IN THE SUPREME COURT OF THE STATE OF MONTANA
No. DA 16-0739

ALPS PROPERTY & CASUALTY INSURANCE COMPANY, d/b/a Attorneys Liability Protection Society, A Risk Retention Group,

Plaintiff and Appellee,

v.

McLEAN & McLEAN, PLLP; DAVID McLEAN; MICHAEL McLEAN and MIANTAE McCONNELL,

Defendants and Appellants.

McLEAN & McLEAN, PLLP and MICHAEL McLEAN,

Counter Plaintiffs and Appellants,

v.

ALPS PROPERTY & CASUALTY INSURANCE COMPANY,

Counter Defendant and Appellee.

JOSEPH F. MICHELETTI and MARILYN C. MICHELETTI,

Intervenors and Appellants.

ANSWER BRIEF OF APPELLEE ALPS PROPERTY & CASUALTY INSURANCE COMPANY

On Appeal from the Third Judicial District Court,
Deer Lodge County, Montana
Cause No. DV-14-82
Honorable James A. Haynes

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ATTACHED EXHIBITS

Exhibit 1: Order of Discipline, David McLean, PR14-0737, District Court Record, Dkt. 34, Ex. A 1

Exhibit 2: Findings of the Office of Disciplinary Counsel, David McLean, District Court Record, Dkt. 34, Ex. B. 2

Exhibit 3: Affidavit of Erika Taylor, without exhibits, District Court Record, Dkt. 35. 3

All references to "Tabs" in ALPS's Response Brief refer to the Appendix to M&M's Joint Opening Brief. Attached Exhibits 1, 2, and 3 are contained within ALPS's Response Brief, not in a separate Appendix.

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ISSUES PRESENTED

1. Did the District Court correctly uphold ALPS's rescission of the Policy based on admitted and material misrepresentations in the Firm's application for insurance?
2. Did the District Court correctly determine that the claims asserted by third parties were not covered based on rescission, and in the alternative, based on the exclusions in the Policy?

STATEMENT OF THE CASE

McLean & McLean ("M&M") and the firm's two attorneys, David and Michael McLean, were insured by Attorney Liability Protective Society ("ALPS") under Policy No. ALPS 7804-11. (Policy, Tab 9). The most recent Policy's term extended from January 1, 2014 through January 1, 2015. *Id.* The Policy is a "claims made and reported" policy, and no coverage exists under the Policy for claims reported to ALPS before January 1, 2014 or after January 1, 2015. *Id.*

During the period from January 1, 2014 until January 1, 2015, ALPS received four notices of claims under the policy. As set forth in M&M's Statement of the Case, M&M provided notice of David's thefts on July 24, 2014; Miantae McConnell and Lillian Johnson advised ALPS of their claims in August, 2014; and the Michelettis notified ALPS of a claim on October 16, 2014. (M&M

Brief, p. 9-10). McConnell's and Johnson's claims were also contained in M&M's original notice on July 24, 2014, as those claims arose from David's thefts.

ALPS accepted defense of the third-party claims subject to a complete reservation of rights, and filed this declaratory action. (Dkt. 1, ¶38; Dkt. 4, ¶II). The District Court entered judgment in favor of ALPS. This is an appeal from two Orders, one addressing the insureds, and the other addressing the third-party claimants. In the first order, the District Court determined that ALPS had properly rescinded the Policy issued to M&M, Michael McLean, and David McLean, and that the Policy was void *ab initio.* (Tab 3, p. 46). In the second Order, the District Court determined that ALPS properly rescinded the Policy with respect to third-party claimants Miantae McConnell ("McConnell") and Joseph and Marilyn Micheletti ("the Michelettis"). (Tab 2, p. 38). The District Court also held that even absent the valid rescission, McConnell's and Michelettis' claims did not fall within the scope of the Policy's coverage. (Tab 2, p. 38).

Concessions of the parties on appeal have further limited the scope of this Court's review. David McLean ("David") has withdrawn his appeal, and therefore accepts the District Court's determination that no coverage is available. Only one third-party claimant – the Michelettis – have filed a brief on appeal. M&M and Michael McLean ("Michael") concede that only the "non-theft-related claims"

remain at issue on appeal, stating in their brief:

> ALPS . . . received multiple claims against David and M&M. Some related to thefts. Others were for alleged acts of malpractice wholly unrelated to the thefts. M&M's and Michael's appeal is only about coverage for the claims for non-theft-related acts of malpractice. The Lawyer's [sic] Fund for Client Protection handled the theft claims. (M&M Brief, p. 1).

Thus, M&M admits that no coverage exists for the theft-related claims. Both Johnson's claim and McConnell's claim are theft-related claims. (Order in PR 14-0737, Ex. 1 attached). Based on David's withdrawal from the appeal and the admission by M&M and Michael that no coverage exists for theft-related claims, only the Michelettis' claim against David is at issue on appeal. No other claims reported during the "claims made" policy period are still at issue.

STATEMENT OF THE FACTS

Father and son David and Michael McLean began practicing as "McLean & McLean, PLLP" in 2002, with David as the managing partner and Michael as the only other attorney involved in the practice. (Dkt. 1, Complaint, ¶¶10 and 11; Dkt. 4, David's Answer ¶ II, Dkt. 5, Michael's Answer ¶II). From 2008 until 2014, the McLeans were insured by ALPS. (Policy, Tab 9). During this six-year period, David misappropriated hundreds of thousands of dollars of funds belonging to M&M's clients and the Montana Chapter of the American Board of Trial Advocacy ("ABOTA"), for which David served as secretary/treasurer. (Ex. 1 and

2, attached). Also during this period, David signed renewal applications each year indicating that neither he nor any member of the firm was aware of any facts or circumstances that could reasonably be expected to be the basis of a claim against M&M or the attorneys. (Dkt. 35, Taylor Aff. Exs. 1-7; 2013 App., Tab 10). Each year, the firm accepted the Policy, thus verifying that each attorney "agrees with, represents to and assured [ALPS] that the statements, information and representations" in the applications are true and correct. (Tab 9, Policy, Conditions §4.14.1).

On July 24, 2014, M&M provided notice to ALPS of the firm's report to the Office of Disciplinary Counsel ("ODC") regarding David's theft of client funds. (Dkt. 1, ¶36; Dkt. 4, ¶2; M&M Brief, p. 9). On August 15, 2014, McConnell advised ALPS of her claim, which was also included in the ODC notice. (Dkt. 1, ¶15, Dkt. 4, ¶II). On August 21, 2014, Lillian Johnson provided notice to ALPS of her claim, which was also included in the ODC notice. (Dkt. 1, ¶16, Dkt. 4, ¶II). On September 24, 2014, ALPS reserved its rights regarding the potential claims arising from theft, and the third-party claims actually asserted by Johnson and McConnell. (Dkt. 36, Ex. 2).

ALPS rescinded the Policy on September 26, 2014, and refunded the premium of $6,657.59. (Tab 6). The notice stated the "reason for rescission":

> Misrepresentation, omission, concealment of facts, and incorrect statements by the Named Insured in the application for insurance which were fraudulent and material to the acceptance of the risk and hazard assumed by the Company. The Company in good faith would not have issued the policy if the true facts had been made known to the Company as required by the application for insurance or otherwise. (Tab 6).

M&M returned the tender of refund. (Dkt. 12, ¶14, Dkt. 17. ¶14). ALPS accepted the defense under a reservation of rights and filed this declaratory action. (Dkt. 1, ¶38, Dkt. 4, ¶II). Subsequently, on October 16, 2014, the Michelettis placed ALPS on notice of a claim against David on October 16, 2014. (Dkt. 51, ¶11).

On March 17, 2015, this Court issued an Order of Discipline, disbarring David and requiring restitution. (Ex. 1, attached). The Court adopted the Office of Disciplinary Counsel's Findings of Fact (Ex.2), which establish that beginning in 2008 and continuing into 2014, David misappropriated hundreds of thousands of dollars of funds belonging to M&M's clients and ABOTA, for which David served as secretary/treasurer. This Court specifically found that David stole funds from Johnson and McConnell. (Ex. 1 and 2, attached).

STANDARD OF REVIEW

This Court reviews a district court's grant or denial of summary judgment *de novo*, applying the same criteria as the district courts. *Kaufman Bros. v. Home Value Stores, Inc.*, 2012 MT 121, ¶ 6, 365 Mont. 196, 198, 279 P.3d 157, 159.

Summary judgment is appropriate where there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. M.R.Civ.P. 56. This Court reviews a district court's conclusions of law *de novo*. *Lamb v. Dist. Ct. Of Fourth Judicial District*, 2010 MT 141, ¶11, 356 Mont. 534, 234 P.3d 893.

SUMMARY OF ARGUMENT

Policy No. ALPS7804-11 – the contract at issue – has a policy period beginning January 1, 2014 and ending January 1, 2015. (See Policy, Tab 9). No coverage exists under the Policy for several reasons. First and foremost, because David made material misrepresentations in the application of insurance regarding his misappropriation of client funds, the Policy has been rescinded and is void *ab initio*. Second, all the claims arising from the misappropriation of funds are excluded from Policy coverage. Third, all the claims of Third Parties (Johnson, Micheletti, and McConnell) are excluded from the Policy because an insured (David) knew of the potential claims prior to the Policy's effective date and did not disclose the acts and omissions in the application. Based on the undisputed facts, the policy language, and the law set forth below, ALPS has no duty to provide defense or indemnity to M&M, David McLean, or Michael McLean for any claims arising during the claims-made policy period. In addition, the third-party claimants had no entitlement to coverage under the Policy.

ARGUMENT

I. THE DISTRICT COURT PROPERLY UPHELD ALPS'S RESCISSION OF THE POLICY.

Under Montana law, a party may rescind a contract if the rescinding party's consent was "obtained through duress, menace, fraud, or undue influence." §28-2-1711, MCA. Montana law provides more specific guidance with respect to rescission of contracts of insurance. Pursuant to §33-15-403, MCA, "misrepresentations, omissions, concealment of facts, and incorrect statements" contained in an application of coverage preclude recovery under the policy if the representations are fraudulent, material, OR the insurer would not have issued the policy with knowledge of the true facts. §33-15-403, MCA. "[T]his statute should be read in the disjunctive," such that ALPS need only establish one of the three bases to rescind the Policy. *Schneider v. Minn. Mut. Life Ins. Co.*, 247 Mont. 334, 338, 806 P.2d 1032, 1035 (1991).

The District Court upheld ALPS's rescission of the M&M policy based upon these controlling statutes. (Order, Appendix, Tab 3, p. 24). The District Court correctly determined that ALPS met all requirements to rescind the policy based on David McLean's misrepresentations in the firm's application for insurance, which concealed his longtime misappropriation of numerous clients' funds. *Id.*

A. ALPS Met the Requirements of §28-2-1713 by Rescinding Promptly and Returning the Premium.

Section 28-2-1713 requires the rescinding party to rescind promptly upon discovery of the facts supporting rescission. *Id.* The District Court determined that ALPS rescinded promptly, within two months after being informed of David's misconduct. (Order, Tab 3 at 25). No party disputed the promptness of this timing in the District Court, and no party disputes it on appeal. *Id.*

Section 28-2-1713 also requires the rescinding party to "restore to the other party everything of value that the rescinding party has received from the other party under the contract or shall offer to restore everything of value. . . ." §28-2-1713 (2), MCA. The parties admitted below, just as they admit here, that ALPS attempted to restore the entire premium of $6,657.59 to M&M, but the firm returned the tender of the premium. (Order, Tab 3, p. 25; M&M Brief, p. 12). The District Court correctly determined that ALPS "restored or offered to restore to M&M everything of value that ALPS received from M&M," as required by the statute. *Id.*

M&M argues that "tendering back the premium was not sufficient to restore the insureds or the clients to the position they were in on January 1, 2014." (M&M Brief, p. 32). M&M theorizes that ALPS should have continued to provide coverage to M&M and Michael because "absent their ability to obtain substitute

coverage, they were not put back into their original position." (M&M Brief, p. 33). But based on the unrefuted record, nothing could have restored to M&M and Michael the ability to obtain coverage for the claims incurred while partnering with David. To the contrary, the undisputed record establishes that had M&M submitted a truthful application for insurance, detailing the actual potential claims that existed in January of 2014, M&M would not have been able to obtain coverage. (Taylor Aff., Ex. 3, ¶12, attached).

The only evidence of insurability presented to the District Court was presented by ALPS. The undisputed affidavit of Erika Taylor, underwriting manager for ALPS, establishes that "ALPS would not have issued the Policy to M&M and its attorneys had the true facts been known regarding David McLean's misappropriation of funds." (Ex. 3, ¶12, attached). Plaintiffs presented not one scintilla of evidence to indicate that ALPS, or any other insurer, would have provided insurance for M&M and Michael when presented with the true facts of the misappropriation of client funds systematically taking place over a period of six years at M&M.

In essence, M&M claims that rescission of the ALPS policy deprived them of the ability to obtain substitute coverage. As recognized by the Ninth Circuit Court of Appeals, interpreting Montana law, losing the opportunity to seek

coverage is distinct from the loss of coverage. *St. Paul Fire & Marine Ins. Co. v. American Bank*, 33 F.3d 1159, 1162 (9th Cir. 1994). A litigant claiming detriment caused by loss of the opportunity to obtain coverage must establish that coverage was actually available. *Id.* M&M failed to establish that ALPS or any other insurer would have provided coverage to M&M and Michael in January 2014 had the insurer been informed of the true facts.

Moreover, M&M has failed to establish that Michael is uninsured for any period other than the policy period of the rescinded contract, and has failed to identify any claims that name him individually. Michael testified by affidavit that ALPS denied Michael's application for Extended Reporting Period Coverage. (Aff., Tab 4, ¶13). The Policy specifically states that the Extended Coverage is not available when ALPS rescinds a policy based on misrepresentations in the application. (Tab 9, §4.4.5(b)). Other than ALPS's denial of Extended Reporting Period Endorsement, Michael has not established that he is unable to obtain insurance from other insurers or that he is currently uninsured. (Aff., Tab 4).

In addition to the failure of Plaintiffs' proof, the statute does not require that ALPS put the insureds "back into their original position" in 2014, as argued by M&M. (M&M Brief, p. 32). The statute requires only that ALPS offer to restore everything of value received by ALPS. §28-2-1713(2), MCA. ALPS did just that,

when it returned the premium, the only thing of value received by ALPS. As noted by this Court,"an absolute and literal restoration of the parties to their former condition is not required; it is sufficient that such restoration be made as is reasonably possible and such as the merits of the case demand." *Scott v. Hjelm*, 188 Mont. 375, 380, 613 P.2d 1385, 1387 (1990).

Rescission is a rare remedy, but Montana statute clearly allows it in egregious situations like this one, where one party to the contract provided completely false and material information to the other party to the contract for at least six years. ALPS met the requirements of §28-2-1713 by rescinding promptly and returning the premium.

B. ALPS Met the Requirements of §33-15-403, MCA by Establishing that David McLean Obtained Coverage for the Firm Based on Misrepresentations in the Application.

In addition to the requirements for rescission of any contract set forth in §28-2-1713, ALPS met the specific requirements for rescission of an insurance contract set forth in §33-15-403, MCA. The statute provides that "misrepresentations, omissions, concealment of facts, and incorrect statements" contained in an application for coverage preclude recovery under the policy if the representations are:

a. fraudulent;

b. material either to the acceptance of the risk or to the hazard assumed by the insurer; or

c. the insurer in good faith would either not have issued the policy or contract or would not have issued a policy or contract in as large an amount or at the same premium or rate or would not have provided coverage with respect to the hazard resulting in the loss if the true facts had been made known to the insurer as required either by the application for the policy or contract or otherwise.

§33-15-403, MCA.

To meet the statutory requirements for rescinding a policy based on misrepresentations in the application, ALPS need only establish one of the three bases: fraud; materiality, *or* that ALPS would not have issued the Policy. *Schneider*, 247 Mont. at 338, 806 P.2d at 1035. ALPS established all three bases for rescission, and the District Court correctly relied upon two bases in voiding the Policy.

1. The Misrepresentations Were Material.

Pursuant to §33-15-403(2)(b), ALPS had the right to rescind the Policy based on M&M's "[m]isrepresentations, omissions, concealment of facts, and incorrect statements" in its November 14, 2013 application that were "material either to the acceptance of the risk or to the hazard assumed by" ALPS. For purposes of §33-15-403(2)(b), "[t]he materiality of an insured's misrepresentation is determined by the extent the false answer initially influenced the insurer to

assume the risk of coverage." *Schneider*, 247 Mont. at 339, 806 P.2d at 1035.

This Court addressed this exact issue of materiality in *Schlemmer v. N. Cent. Life Ins. Co.*, 2001 MT 256, ¶ 17, 307 Mont. 203, 207, 37 P.3d 63, 65. In that case, an insured seeking life insurance did not disclose that he had been diagnosed with lung disease. The insured questioned the materiality of the misrepresentation. This Court held that questions in an application requesting specific information establish materiality in and of themselves. *Id.*

Other courts agree. In *Unionamerica Ins. Co. v. Fort Miller Grp., Inc.*, 490 F.Supp.2d 1254 (N.D. Cal. 2008), *aff'd* 379 F. App'x 598, 599 (9th Cir. 2010), the California federal district court held that a question of fact existed as to the materiality of the insured's misrepresentation in the policy application. The Ninth Circuit Court of Appeals reversed that ruling, holding that "the fact that the insurer has demanded answers to specific questions in an application for insurance is in itself usually sufficient to establish materiality as a matter of law." 379 F. App'x 598, 599 (9th Cir. 2010), *quoting Thompson v. Occidental Life Ins. Co.* 9 Cal.3d 904 (1973).

In *Schlemmer*, this Court did not directly address rescission, but instead held that the material misrepresentation on the application justified the insurer's "denial of coverage" under the policy. *Id.* at ¶25. Courts in other jurisdictions,

applying statutes similar or identical to §33-15-403(2), have routinely rescinded policies based on misrepresentations in the application. For example, the Illinois Supreme Court recently upheld rescission of a firm's malpractice insurance with respect to the entire firm, although only one firm member made misrepresentations in the application. *Illinois State Bar Association v. Tuzzolino and Terpinas*, 27 N.E.3rd 67, 75 (Ill. 2015). The Illinois Court interpreted a statute similar to §33-15-403(b), MCA.

In *Continental Casualty Co. v. Law Offices of Melbourne Mills, Jr., PLLC*, 676 F.3d 534, 538 (6th Cir. 2012), the insured attorney knew he had misappropriated funds from settlement proceeds in excess of the amount authorized in his fee agreement, and he knew that the state bar association was investigating the matter. Nevertheless, he represented on his malpractice insurance application that he had no knowledge of "claims, or acts or omissions that may reasonably be expected to be a claim against the firm." The Sixth Circuit Court of Appeals held this representation on his insurance application was "a misrepresentation that was material to [the insurer]'s acceptance of risk" justifying rescission. The language in the Kentucky statute relied upon by the Sixth Circuit is identical to §33-15-403(b), MCA.

Similarly, in *Westport Ins. Corp. v. Gionfriddo*, 524 F. Supp. 2d 167, 176

(D. Conn. 2007), an attorney misappropriated client funds, but he represented on his malpractice insurance application that he had no knowledge of any acts, errors, or omissions that might be the basis of a claim against him. The court held that "knowledge that [the attorney] was involved in numerous acts of misconduct, including but not limited to misuse of client funds, that could have formed the basis for claims against him would have substantially affected [the insurer's] decision to provide [the attorney] with coverage." *Id.* Therefore, rescission of the policy was justified and the coverage was declared "void *ab initio*." *Id.* at 177.

Here, the uncontroverted facts are that M&M, through its managing partner David, made misrepresentations and omissions in its applications for insurance with ALPS. David averred in the application that M&M had no knowledge of any facts that could reasonably be expected to be the basis of any claim. (Tab 10). These representations were false, as admitted by David in his sworn affidavit. (Tab 5). These misrepresentations and omissions were material as a matter of law. Questions in an application requesting specific information establish materiality in and of themselves. *Schlemmer* at ¶17. Clearly, the theft of client funds could reasonably be expected to be the basis of a claim against David or the firm.

M&M makes a half-hearted attempt to dispute the materiality of David's misrepresentations regarding potential claims in the application. (M&M Brief, p.

37-38). While not disputing that ALPS asked questions regarding potential claims in its application, M&M argues that ALPS could have asked a different question in its application, and suggests that ALPS should have inquired about malfeasance. M&M's arguments are not supported by law or facts. M&M provides not a single legal authority supporting the theory that ALPS was required to ask the suggested questions. M&M provides not a single fact or exhibit establishing that any other insurer asks such a question in application materials.

Finally, the Policy itself establishes materiality, stating that the Policy "**is issued in reliance** upon the truth" of the "statements . . . and representations" in the applications. (Tab 9, §4.14.1, *bold added*). No genuine issue of fact exists as to the materiality of the misrepresentations in the applications. The District Court properly rescinded the Policy and declared it void *ab initio.*

2. ALPS would not have issued the Policy absent the Misrepresentations of David McLean.

Rescission of the M&M policy is statutorily permitted if ALPS would not have issued the contract with respect to the hazard resulting in the loss if the true facts had been made known to ALPS. §33-15-403, MCA. The District Court relied upon uncontested evidence and found that ALPS met these criteria, citing David's misrepresentations in the application and underwriter Erika Taylor's uncontested affidavit that ALPS would not have issued the Policy had it known of

the potential claims. (Order, Tab 3, p. 25-26).

M&M does not dispute that crucial undisputable fact: ALPS would not have issued the Policy had it known of the potential claims known to David but not disclosed on his application. (Ex. 3, ¶12, attached). Instead, without any citation to authority, M&M argues that the "prudent insurer rule should apply." (M&M Brief, p. 42). M&M does not explain this alleged "rule" other than stating again that ALPS should have asked M&M about misappropriation of funds.

Section 33-15-403 establishes exactly how an insurer should act prudently. As held by this Court, "an omission or misrepresentation may be material if, had the truth been known, the reasonable and prudent insurer would not have issued the policy." *Schneider*, 247 Mont. at 339, 806 P.2d at 1036. Many courts have held that insurers reasonably rescinded malpractice policies based on misrepresentations regarding misconduct. *Tuzzolino and Terpinas*, 27 N.E.3rd at 75; *Continental Casualty Co.*, 676 F.3d at 538; *Gionfriddo*, 524 F. Supp. 2d at 176 (D. Conn. 2007). Certainly, no insurer would accept the risk presented by a firm with an attorney who was stealing client funds for six years, especially since evidence of theft or malfeasance often signals other systemic problems in the firm's practice, as was the case here.

C. Rescission of the 2014 Policy is Fair and Equitable in the Context of this "Claims Made" Policy.

ALPS only rescinded Policy No. ALPS7894-11, for the policy term January 1, 2014 to January 1, 2015. (Rescission Notice, Tab 6). There is no evidence that ALPS rejected any claims made under prior policy terms. To the contrary, the only claims before the District Court were the claims made and reported to ALPS from January 1, 2014 to January 1, 2015: the theft claims reported by M&M to ALPS and the ODC in July 2014, which included McConnell and Johnson; and the third-party claims asserted by Michelettis, McConnell, and Johnson against ALPS. (M&M Brief, p. 9-10).

M&M sets forth a "slippery slope" illustration of the harm which could be caused to consumers if an insurer is allowed in the fourth year of a policy to rescind four years of coverage based on misrepresentations in the first year. (M&M Brief, p. 23-24). M&M's hypothetical has no bearing on this case because ALPS only rescinded the 2014 policy. In addition, M&M's "illustration" ignores the crucial distinction between an occurrence-based policy and a "claims made and reported" policy. The ALPS policy, like most professional liability policies, is strictly confined to claims made and reported during the policy period. The claims made during the period of the rescinded policy are now known, and those claims are barred by rescission and on other bases. Under these circumstances, rescission

is the just and equitable remedy for the firm's misrepresentations in its insurance application.

Michael contends he is eligible for an Extended Reporting Period Endorsement ("ERPE") or "tail coverage." The Policy specifies the conditions for issuance of an ERPE and unequivocally placed Michael on notice that ALPS would not issue an ERPE to any member of a firm whose policy was rescinded under these exact circumstances. The Policy provides that "[n]o Extended Reporting Period Endorsement under this section, nor any continuation thereof, shall be available" where ALPS "cancels or rescinds this Policy or any other policy for misrepresentation in any application or other submission to [ALPS]." (Policy, Tab 9, §4.4.5).

Thus, in the context of this "claims made" policy, the effects of rescission are limited and equitable. Every claim made and reported to ALPS during that policy period is not only barred by rescission, but also excluded by policy provisions. The only "claims" excluded solely based on rescission are hypothetical future claims under an Extended Reporting Period Endorsement which ALPS never issued to M&M or Michael. Refusing to provide tail coverage to M&M or Michael is not only equitable, but is clearly set forth in the Policy terms. No Extended Reporting Period Endorsement "shall be available" when the

policy is rescinded. §4.4.5(b).

The District Court correctly rescinded the Policy based on controlling statutes and the undisputed facts. Rescission is specifically allowed by law based on misrepresentations in the insurance contract, and is equitable in this situation, given the egregiousness of the applicant firm's conduct.

II. THE "INNOCENT INSURED" DOCTRINE DOES NOT APPLY.

Commingled in M&M's brief are two different and distinct "innocent insured" legal theories. M&M argues that the District Court should have applied the Policy's limited "innocent insured" provision, and also argues that this Court should adopt a common law doctrine of "innocent insured" to allow coverage despite clear exclusions *and* rescission. Neither the policy provision nor the common law doctrine apply here.

A. The Policy's Innocent Insured Provision is Limited and Does not Apply to Rescission.

M&M erroneously argues that the limited "innocent-insured" provision in the Policy precludes ALPS from rescinding the Policy. The Policy provides:

> 4.3 INNOCENT - INSURED COVERAGE
>
> 4.3.1 Whenever a Claim otherwise covered by this Policy would be excluded based on Section 3.1.1, coverage will be afforded to any individual Insured who did not personally commit, or personally participate in committing, any such act, error or omission, or in causing such Personal Injury, and who did not remain passive after

> learning of the act, error, omission, or Personal Injury, provided that each such individual Insured shall have immediately notified the Company and complied with all obligations under this Policy once said Insured obtained knowledge of the act, error, omission or Personal Injury. Nothing in this section shall be interpreted to affect any coverage to a Named Insured that is an entity other than an individual. (Policy, Tab 9).

By its terms, the coverage afforded to an "innocent insured" is limited to coverage excluded to another insured under §3.1.1. That exclusion precludes coverage for "dishonest, fraudulent, criminal, malicious or intentionally wrongful or harmful acts." Application of the "innocent insured" provision is specifically limited to coverage denied under exclusion §3.1.1 by the Policy's explicit terms. ALPS denied coverage based on rescission and several other policy exclusions.

M&M attempts to expand this "innocent insured" exception to §3.1.1 to allow coverage despite rescission and despite the applicability of the many policy provisions which exclude coverage in addition to Exclusion 3.1.1. M&M ignores a basic premise of insurance law. "An exception to an exclusion does not create coverage or provide an additional basis for coverage." *Continental Cas. Co. v. Donald T. Bertucci, Ltd.,* 926 N.E.2d 833, 846 (Ill. Ct. App. 2010). *See also Stillwater Condo. Ass'n v. Amer. Home Ins. Co.*, 508 F.Supp. 1075, 1079 (D. Mont. 1981).

The ALPS Policy contemplates rescission for misrepresentations in the

application. (Policy, Tab 4, §4.4.5). State statute specifically governs misrepresentation in insurance applications and allows for rescission. Numerous Policy provisions other than Exclusion 3.1.1, preclude coverage. The innocent insured exception applies only to Exclusion 3.1.1, and does not create coverage where none exists based on rescission and other policy exclusions.

B. The Common Law "Innocent Insured Doctrine" Has Been Properly Rejected by This Court.

The so-called "innocent insured doctrine" does not apply to preclude rescission of an insurance policy under Montana law. This Court rejected the doctrine decades ago. In *Woodhouse v. Farmers Union Mut. Ins. Co.*, 241 Mont. 69, 785 P.2d 192 (1990), Patricia Woodhouse lost her personal property in a fire intentionally started by her estranged husband. Patricia sought recovery from Farmers for her personal property, but the policy excluded coverage for "loss caused directly or indirectly by . . . intentional loss . . . arising out of any acted committed by or at the direction of an insured." *Id.* at 70, 785 P.2d at 193. Woodhouse raised the innocent insured doctrine. *Id.* at 71, 785 P.2d at 194. This Court refused to consider the innocence of the co-insured, reasoning:

> Although the results are undeniably harsh for Patricia Woodhouse, the clear meaning of the contract must govern here. We concur with Farmers that this is, plainly and simply, a contract case. The provision clearly and unequivocally states that a loss caused by an intentional act of an insured party bars coverage. Alan Woodhouse

> was clearly an "insured," and his act was clearly intentional. Accordingly, we find that the loss was not covered. . . ."

Id. at 72, 785 P.2d at 194. In *Tyler v. Fireman's Fund Ins. Co.*, 255 Mont. 174, 176, 841 P.2d 538, 540 (1992), this Court reiterated and affirmed the reasoning of *Woodhouse.*

Montana law is settled, but M&M argues that this Court should adopt the reasoning of the courts in *Jensen v. Snellings*, 841 F.2d 600, 617 (5th Cir. 1988); *DeBruyne v. Clay*, 1999 WL 782481 (S.D.N.Y. 1999): and *Perl v. St. Paul Fire and Marine Ins. Co.*, 345 N.2d 209, 216 (Minn. 1984). None of those cases involve analysis of a rescinded policy. Neither *Jensen* nor *Perl* even mention the innocent insured doctrine, and neither involve a rescinded policy. *DeBruyne* addresses an "innocent partner" exception to an exclusion, not the common law doctrine.

M&M also relies on *Hogs Unlimited v. Farm Bureau Mut. Ins. Co.*, 401 N.W.2d 381, 385 (Minn. 1987). That case did not involve a claims made policy, did not involve malpractice, and analyzed a voiding clause, not a policy void *ab initio* based on misrepresentations in the application for coverage. Moreover, this Court has already rejected the innocent insured doctrine in the similar context of arson, and thus the basis of the *Hogs Unlimited* ruling does not apply under Montana law. *See Woodhouse* and *Tyler*, *supra.*

M&M mistakenly asserts that adopting an "innocent insured" doctrine is a "modern trend," citing a 1987 Minnesota decision. (M&M Brief, p. 24). This is not the case with respect to rescission based on one attorney's misrepresentations in the application, regardless of the knowledge of other attorneys in the firm. In *Am. Guar. & Liab. Ins. Co. v. Jaques Admiralty Law Firm*, 121 F. App'x 573, 575 (6th Cir. 2005), the Sixth Circuit noted that the "prevailing rule . . . is that a misrepresentation by an insured in an application for insurance permits rescission even as to innocent insureds." *Id.* This is especially true with respect to rescission. "[T]he rationale for applying the innocent insured doctrine to questions of policy exclusions and insurance coverage is absent from the rescission context" because "[i]n the case of a misrepresentation that materially affects the acceptance of the risk, the issue is the effect of that misrepresentation on the validity of the policy as a whole." *Id.*

In *Home Ins. Co. v. Dunn*, 963 F.2d 1023 (7th Cir. 1992), a firm's "crooked attorney" misrepresented in the insurance application that he knew of no claims, though he was embezzling funds belonging to the firm's clients. *Id.* at 1024. Relying on a rescission statute similar to §33-15-403, the Seventh Circuit held that the policy was properly rescinded as to all insureds. *Id.* at 1026. There, as here, "there is no question that, in the absence of the [attorney Cooper's] false

statement, [the insurer] never would have issued the policy to Cooper or any of the attorneys in the firm. *Id.*

The most recent, applicable, and persuasive authority is the decision relied upon by the District Court, *Tuzzolino & Terpinas*. In that case, the Illinois Supreme Court affirmed rescission of a claims-made professional liability policy based on one partner's failure to disclose a known claim on the firm's renewal application. *Id.,* 27 N.E.3d at 73-4. The Court relied upon an Illinois statute that, like §33-15-403, MCA, allowed rescission based on a misrepresentation in the application which "materially affects either the acceptance of the risk or the hazard assumed by the company." *Id.* at 71.

The District Court correctly relied upon Montana case law, the language of §33-15-403, and the "prevailing rule" that the innocent insured doctrine does not apply to rescission based on insurance misrepresentation statutes.

C. Michael McLean and M&M are Not Entitled to Coverage as Innocent Insureds.

M&M argues that rescission is a "harsh" remedy, and that coverage should not be denied to David's partner, Michael, "unless the language of the Policy clearly states that coverage will be excluded as to all insureds because of the misrepresentation by another insured." (M&M Brief, p. 28). Michael ignores the plain language of the contract to which he agreed, and the conditions contained

therein. The Policy states the following "condition" for coverage to apply:

> 4.14. STATEMENTS IN DECLARATIONS AND APPLICATION.
>
> 4.14.1 By acceptance of this Policy, **each Insured agrees** with, represents to and assures the Company that the statements, information and representations in the Declarations, in the application for this Policy, and in the applications for each prior policy issued by the Company to the Insured, are true and correct, that the Declarations and the application form a part of this Policy, and that this Policy is issued in reliance upon the truth of such statements, information, and representations.

(Policy, Tab 9, §4.14, p. 21, *emphasis added*). In addition, the Policy provides that "[n]o Extended Reporting Period Endorsement under this section, nor any continuation thereof, shall be available to the Named Insured" where ALPS "cancels or rescinds this Policy or any other policy for misrepresentation in any application or other submission to [ALPS]." (Policy, Tab 9, §4.4.5).

In accepting the Policy, "each Insured," including Michael, represented to and assured ALPS that David's representations in the application were true and correct. "Each Insured," including Michael, recognized and accepted that ALPS issued the Policy in reliance on those representations in the applications. This point is further emphasized by another condition in the Policy, which defines the "Entire Contract" as the Policy, "including any currently or previously submitted application documents." (Policy, Tab 4, §4.16, p.21).

Moreover, rescinding as to only David would not remedy the many

professional liability problems created by David's misrepresentations in the application. As noted by a Massachusetts federal district court when voiding an Errors and Omissions policy based on one director's misrepresentations in the application:

> Because of the likelihood of joint and several liability being imposed on all directors for the wrongdoing of one, the facts known by Shapiro were highly material not only to his potential liability, but to that of all other directors. Since Shapiro's answer misrepresented the risk incurred in insuring all those covered by the policy, it follows that American Home can avoid responsibility to all the insureds on the basis of that misrepresentation.

Shapiro v. American Home Assur. Co., 584 F.Supp. 1245, 1252 (D.Mass. 1984). Absent rescission of the entire policy, third parties with malfeasance claims against David McLean are likely to bring malpractice claims against Michael McLean based on the firm's failure to discover a six-year history of theft from the firm's trust account.

M&M and the Michelettis argue that ALPS cannot "impute" David's actions and misrepresentations to Michael. The Policy does not "impute" misrepresentations or actions from one firm member to another. Rather, the Policy makes clear that if one lawyer misrepresents material facts in the application, that misrepresentation alone is material, and therefore precludes coverage to all attorneys pursuant to §33-15-403. When rejecting the innocent insured doctrine

in *Woodhouse*, this Court recognized that "the results are undeniably harsh for the [co-insured]," but noted that the "clear meaning of the contract must govern." *Woodhouse*, 241 Mont. at 72, 785 P.2d at 194.

M&M and Michael incorrectly assert that they "are innocent insureds under the common-law doctrine." (M&M Brief, p. 21). Michael may be "innocent" of making representations regarding knowledge of David's misdeeds. He is not innocent, however, of representing that the firm's applications were true and correct and that ALPS could rely on David's representations. It is undisputed that in this small law firm, for a period of over six years beginning in 2008, one attorney (David) misappropriated hundreds of thousands of dollars of funds belonging to M&M's clients and ABOTA. (ODC Findings, Ex. 2, attached). Another attorney, Michael, failed to discover this long-term violation of clients' assets until July 22, 2014. (Michael's Aff., Tab 4, ¶12). Michael had a responsibility under the Rules of Professional Conduct to "make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct." Rule 5.1(a). The firm failed to put systems in place to discover this abuse, and yet Michael annually represented to ALPS that ALPS could rely upon David's representations regarding the firm's activities. (Policy, Tab 9, §4.14.1).

III. NO COVERAGE EXISTS FOR THE CLAIMS MADE AND REPORTED IN 2014.

ALPS received four notices during the 2014 policy period: (1) M&M's report to the ODC and ALPS of the theft claims; and the three third-party claims submitted to ALPS during 2014: the Michelettis, McConnell, and Johnson. The parties agree that the theft-related claims are not at issue in this appeal. (M&M Brief, p. 9). Theft is not covered pursuant to many policy provisions.

As to the individuals who notified ALPS of claims, Johnson and McConnell alleged theft of funds by David, and their claims have been adjudicated in the ODC proceedings. (See Ex. 1 and 2, attached). Johnson initially appeared in this declaratory action, but was dismissed on her own motion upon the stipulation that she would be bound by the court's decision. (Dkt. 23). McConnell filed a notice of appeal but has not filed a brief. The Michelettis have appeared and filed a brief in this appeal, and ALPS will direct its response primarily to the Michelettis.

The District Court properly determined that no coverage existed for the third parties, including the Michelettis, on two grounds: (1) the Policy was rescinded and void; and (2) even prior to rescission, the third-party claims fell outside the coverage afforded by the Policy. (Order, Tab 2, p. 38).

A. No Coverage Exists for the Third-Party Claimants Such as the Michelettis Under a Void Policy.

Montana law specifically provides that recovery is precluded under an insurance policy if representations in the application are fraudulent, material, or if the misrepresentation is relied upon by the insurer. §33-15-403, MCA. The District Court properly declared the Policy void *ab initio* pursuant to this statute. "A void contract is no contract at all; it binds no one and is a mere nullity." *Scott D. Erler, DDS Profit Sharing Plan v. Creative Finance & Investment, LLC*, 2009 MT 36, ¶32, 349 Mont. 207, 218, 203 P.3d 744, 753. Void contracts "do not legally exist and transfer no rights." *Id.* at ¶37.

As determined by the District Court, the Policy is void *ab initio.* It does not exist and transfers no rights to third parties. The Policy is a mere nullity, and provides no coverage to the Michelettis, McConnell, and Johnson. *Id.*

B. The Third-Party Claimants Were Not Entitled to Coverage Even Absent Rescission.

1. The Claims are Excluded by Policy Provisions §1.1.2 and §3.1.5 Because David Knew or Should have Known of the Claims prior to the Policy's Effective Date.

Even if the Policy were not void *ab initio,* it would not provide coverage for the Michelettis, Johnson, or McConnell. The Policy requires that "at the Effective Date of this Policy, **no Insured** knew or reasonably should have known or

foreseen that the act, error, omission or Personal Injury might be the basis of a Claim." (Policy, Tab 9, §1.1.2).

In addition, the Policy excludes from coverage any Claim arising from or in connection with "[a]ny act, error, omission or personal injury that occurred prior to the Effective Date of this Policy if . . . [p]rior to the Effective Date of the Policy, **any Insured** gave or should have given, to any insurer, notice of a Claim or potential Claim arising from the act, error, omission, or Personal Injury, or from any act, error, omission, or Personal Injury in Related Professional Services." (Tab 9, §3.1.5). Disclosure of knowledge of potential claims prior to the Effective Date is a condition precedent to insurance coverage. *Bryan Bros. Inc. v. Cont'l Cas. Co.*, 660 F.3d 827, 830-31 (4th Cir. 2011). Failure to disclose the potential claims by a single attorney precludes coverage. "[P]rior knowledge provision is a condition precedent to coverage" and clearly and unambiguously indicates an insurer's "unwillingness to cover liability arising from prior acts or omissions that any insured might reasonably expect to result in a claim." *Id.*

ALPS's claims-made Policy stated an Effective Date of January 1, 2014. (Tab 9, p. 1). With respect to McConnell, David knew of the existence of facts which might form the basis of McConnell's claim in August 2013. It is undisputed that David forged McConnell's signature on August 6, 2013 and stole

the settlement money of $60,000 that same month. (Dkt. 54, McConnell Complaint, Ex. B, ¶16-20; ODC Findings, Ex. 2, ¶46). Thus, David knew McConnell had a potential claim as of August, 2013, months before he filed the application and before the Effective Date. David also knew of the Johnson claim long before the Effective Date. It is undisputed that David forged Johnson's signature on March 15, 2012, and misappropriated Johnson's funds from October 2011 through January 2012. (ODC Findings, Ex. 2, ¶36, attached).[1]

With respect to the Michelettis, David "knew or reasonably should have known or foreseen" that his acts or omissions "might be the basis of a Claim" a year before the Effective Date. David, representing Joe Micheletti, filed a negligence complaint against Costco on December 21, 2012. (Micheletti Counterclaim, Dkt. 41, ¶9). It is undisputed that Costco filed its Answer on January 24, 2013, asserting that Plaintiffs had not filed the suit within the applicable statute of limitations. (Micheletti Counterclaim, Dkt. 41, ¶10).

The Michelettis' argue that a question of fact exists as to what David

[1] Johnson's and McConnell's claims are based on David's theft of client funds. (ODC Findings, Ex. 2, attached). Their claims are also excluded by Policy Exclusion §3.1.8, which provides that the Policy "does not apply to any Claim arising from or in connection with . . . [a]ny conversion, misappropriation or improper commingling or negligent supervision by any person of client or trust account funds or property, or any funds or property of any other person held or controlled by an Insured in any capacity under any authority, including any loss or reduction in value of such funds or property." (Tab 9, §3.1.8).

reasonably knew. The District Court correctly reasoned that "[t]he question is whether on January 1, 2014, David knew or reasonably should have known or foreseen that the act, error, or omission *might* be the basis of a demand for services or money." (Order, Tab 2, p. 21). As noted by the District Court, this Court has recognized that some attorney misconduct "is so obvious that no reasonable juror could not comprehend the lawyer's breach of duty." *Carlson v. Morton*, 229 Mont. 234, 237, 745 P.2d 1133, 1135 (1987). These include "the lawyer's failure to file suit within the appropriate statute of limitations." *Id.*

The Michelettis' repeated assertion that the record does not establish David's knowledge in 2013 is incorrect. In fact, the Michelettis' own counterclaim establishes that on or about January 24, 2013, Costco filed its answer asserting that David, representing the Michelettis, missed the applicable statute of limitations. (Micheletti Counterclaim, Dkt. 41, ¶10). The District Court cited the Costco case filing in its Order. (Tab 2, p. 10). The record establishes that Costco notified David of the statute of limitations problem in its Answer in January 2013, before David submitted his application for the 2014 Policy and before the Policy's effective date.

Montana law provides that failure to file suit within the statute of limitations is an obvious error constituting malpractice. *Id.* Whether David thought he had

defenses to such a claim, or whether he thought Costco would abandon the claim, is immaterial. On January 24, 2013, nearly a year before the Policy's Effective Date, David knew of an act which *might* be the basis of a claim.

2. The Michelettis' Claim Falls Outside the "Claims Made" Policy.

Neither the Michelettis or M&M provided notice of the Michelettis' claim to ALPS until October 16, 2014. (Ex. A to Michelettis' Brief, Dkt. 49). ALPS's policy is "claims made" policy. It specifically provides:

> NOTICE: THE POLICY IS A CLAIMS MADE AND REPORTED POLICY. NO COVERAGE EXISTS UNDER THE POLICY FOR A CLAIM WHICH IS FIRST MADE AGAINST THE INSURED OR FIRST REPORTED TO THE COMPANY BEFORE OR AFTER THE POLICY PERIOD OR ANY APPLICABLE EXTENDED REPORTING PERIOD. (Policy, Tab 9, p. 1).

The Michelettis' claim was not made or reported during the policy period. ALPS cancelled the policy on August 20, 2014, effective September 4, 2014. (Ex. 3, ¶15, attached; Dkt. 35, Ex. 10). ALPS rescinded the policy on September 26, 2014, effective January 1, 2014. (Tab 6). The Michelettis' claim was first reported to ALPS two months after notice of cancellation of the policy and one month after rescission. (Dkt. 49, Ex. A). No coverage exists for the Michelettis under this "claims made" policy.

C. The Third-Party Claimants are Not Entitled to Coverage as Intended Third-Party Beneficiaries.

1. The Michelettis are not Intended Third-Party Beneficiaries.

This Court has held that "not everyone who may benefit from performance or suffer from nonperformance of a contract between two other parties is permitted to enforce the contract." *Kurtzenacker v. Davis Surveying, Inc.*, 2012 MT 105, ¶20, 365 Mont. 71, 278 P.3d 1002. Rather, only **intended** third-party beneficiaries may seek to enforce a contract. *Id.* This Court has adopted the Restatement (Second) of Contracts §302's definition of "intended beneficiary."

> (1) Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either
>
> (a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or
>
> (b) the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.

Id. Only "intended" third-party beneficiaries may seek to enforce a contract. *Dick Anderson Constr., Inc. v. Monroe Constr. Co.* 2009 MT 416, ¶46, 353 Mont. 534, 221 P.3d 675.

Third-party claimants are typically third-party beneficiaries to an insurance contract, but they are not necessarily *intended* third-party beneficiaries. In this

case, the Micheletttis (and McConnell and Johnson) are not intended third-party beneficiaries. Here, the void contract between ALPS and M&M does not recognize a right of performance to third parties. *See Philadelphia Indem. Ins. Co. v. Peck*, 2007 WL 2815047 (D. Conn. 2007) (an insurance policy cannot be interpreted as an expression of an intent of the parties that the insurer assume a direct obligation to a third-party claimant).

As shown above, numerous policy provisions specifically preclude coverage – and intended beneficiary status – to these claimants. The Policy does not recognize a right of performance to claimants whose claims are known to the insured prior to the effective date of the policy, or whose claims are not disclosed by the insured, or who make a claim based on misappropriation. In addition to establishing that the Michelettis and McConnell are not entitled to coverage under the Policy, the exclusions also establish that the Michelettis and McConnell are not *intended* third-party beneficiaries under the plain language of the contract. Thus, the Michelettis and McConnell have no right to seek to enforce the policy's provisions. *Dick Anderson Construction*, 2009 MT at ¶47.

2. The Michelettis Are Not Entitled to Coverage Under a Rescinded Policy.

Even if they were intended third-party beneficiaries, the Michelettis would not be entitled to coverage under a rescinded policy. Generally, a third-party

beneficiary's rights are subject to any contract defense that the promisor could assert against the promisee, if the promisee were suing on the contract." *Carpenters Health & Welfare Trust Fund for California v. Bla-Delco Const. Inc.*, 8 F.3d 1365, 1369 (9th Cir. 1993). Thus, the Michelettis and McConnell are subject to the contract defenses available to ALPS, including rescission based on misrepresentations in the application.

This Court has acknowledged that rescission is effective against third parties. In *McLane v. Farmers Ins. Exchange,* (1967) 150 Mont. 116, 432 P.2d 98, the insurer issued a policy on May 22, 1964, and the insured was involved in an accident on June 7, 1964, which injured a third party. *Id.* at 99. Ten days later, on June 17, 1964, the insurer learned that the insured made misrepresentations on the insurance application, but it subsequently continued to accept insurance premium payments from the insured, and it paid damage claims arising from the accident. *Id.* Then, on July 10, 1964, the insurer sent the insured a notice rescinding the insurance policy and attempted to void it *ab initio*. *Id.* This Court recognized the insurer's right to rescind against third parties. *Id*. However, the Court held that the insurer, through its conduct in accepting premium payments and paying damage claims after it learned the insured made misrepresentations on the insurance application, waived its right to rescind the policy promptly. *Id*.

A Montana federal district court has held that rescission of an insurance policy by an insurer after an automobile accident does not preclude coverage for third-party claimants. *Robb v. State Farm Mutual Auto Ins. Co.*, 2006 WL 3354135 (D. Mont. 2006). However, the ruling was limited to coverage required to be provided under the Montana Mandatory Liability Protection Act. Referencing *McLane*, the federal court ruled that the statutory right to rescind an insurance policy based on misrepresentations is abrogated by the compulsory liability protection requirements of the Act. Coverage available to the third party was limited to the amount required to be in place under the Montana Mandatory Liability Protection Act.

Unlike the insurer in *McLane*, in this case ALPS took immediate and consistent action to disavow the validity of the contract. ALPS received notice of David's conduct on July 24, 2014. ALPS cancelled the policy for nonpayment on August 20, 2014, reserved its rights on September 24, 2014, and rescinded the policy with refund of all premiums paid on September 26, 2014. Unlike the insurer in *McLane*, ALPS did not waive its right to rescind. Unlike the insurer in *Robb*, a covered incident did not occur between the time of policy inception and the notice of rescission in an occurrence-based policy. The ALPS policy is a "claims made" policy, and Michelettis did not make or report a claim prior to

rescission. Also, *Robb* is limited to the unique requirements of statutorily mandated auto insurance. Rescission rendered the Policy void as to all parties and third-party claimants.

Under Montana law, a third-party claimant's rights are subject to the defenses available to the insurer under a cancelled policy. In *Steadele v. Colony Ins. Co.*, 2011 MT 208, ¶24, 361 Mont. 459, 260 P.3d 145, the insurer cancelled an insurance policy for non-payment and subsequently received a third-party claim against its insured pursuant to a default judgment entered in favor of the Steadeles. The insured had never provided notice of the Steadeles' claim to Colony. The Montana Supreme Court summarized:

> [T]he Steadeles argue that an insured's failure to notify its insurer does not prevent an injured third-party claimant from being compensated by the insurer for the claimant's damages. Contrary to the Steadeles' contentions, however, their claim against Colony depends entirely on the existence of insurance coverage for the damages the Steadeles' sustained due to MCHC's actions.

Id. The Court denied recovery to the Steadeles as third-party claimants because the policy excluded coverage when an insured failed to give notice of the claim.

Third parties, such as the Michelettis and McConnell, have no greater rights than M&M, the insured. The policy is void as to all parties.

IV. THE REASONABLE EXPECTATIONS DOCTRINE DOES NOT APPLY.

Both Michelettis and M&M rely on the "reasonable expectations doctrine" to support their claims for coverage under the void Policy. The District Court detailed the doctrine's underpinnings in its Opinion, relying on *Meadow Brook, LLP v. First American Title Ins. Co.,* 2014 MT 190, 375 Mont. 509, 329 P.3d 608. (Order, Tab 3, p. 18-19). "The [reasonable expectations] doctrine is inapplicable where the terms of the policy at issue clearly demonstrate an intent to exclude coverage because expectations which are contrary to the clear exclusion are not objectively reasonable." *Id.* at ¶15. The District Court also noted the effect of §33-15-403 on reasonable expectations. The statute, allowing rescission upon misrepresentations in an application, enhances the insurer's defense with respect to application misrepresentations. "Policyholders can properly be expected to anticipate that coverage would be suspended for a violation if it materially increased the risk (or, *a fortiori*, if it caused the loss), regardless of the absence of intent to deceive." (Tab 3, p. 21).

Neither the Michelettis nor M&M have identified any Policy language or insurer representation which would give rise to a reasonable expectation of coverage. The reasonable expectations doctrine is inapplicable where the terms of the policy "clearly demonstrate an intent to exclude coverage," as is the case here.

Fisher ex rel McCartney v. State Farm Ins. Co., 2013 MT 208, ¶20, 371 Mont. 147, 305 P.3d 861. "The reason, of course, is that 'expectations which are contrary to a clear exclusion from coverage are not 'objectively reasonable.'" *Id.*

ALPS's Policy specifically and repeatedly demonstrates that it does not provide coverage for insureds who make misrepresentations in the insurance application (Tab 9, §4.14.1); for claims known to the insured prior to the policy effective date (Tab 9, §1.1.2; §3.1.5); for conversion or misappropriation (Tab 9, §3.1.8; §3.1.9); for claims not "made and reported" during the policy effective period (Tab 9, p. 1); and for malfeasance (Tab 9, §3.1.1). The Policy specifically informs the insured of the possibility of rescission for misrepresentations in the application, indicating that no Extended Reporting Period Endorsement is available if ALPS "rescinds this Policy or any other policy for misrepresentation in any application or other submission to the Company." (Tab 9, §4.4.5 b). In addition to these explicit policy provisions precluding coverage, Montana statutory law specifically allows ALPS to rescind the Policy for misrepresentation. §33-15-403. Neither ALPS nor the Michelettis have an objectively reasonable expectation of coverage under the Policy.

V. PUBLIC POLICY DOES NOT CREATE COVERAGE WHERE NONE EXISTS.

Both M&M and the Michelettis argue throughout their briefs that public policy supports a finding of coverage. These amorphous allegations ignore the long established rule that "Montana public policy is prescribed by the legislature through its enactment of statutes." *Fisher*, 2013 MT 208, ¶25, 371 Mont. at 154, 305 P.3d at 867, *quoting Hardy v. Progressive Specialty Ins. Co.*, 2003 MT 85, ¶ 32, 315 Mont. 107, 67 P.3d 892.

Montana's public policy regarding rescission of this Policy is prescribed by the Legislature in §33-15-403, MCA. The statute allows an insurer to void an insurance contract when an insured obtains that contract with misrepresentations. Nothing in that statutorily prescribed policy allows recovery under a void policy by any person. In fact, the statute states that recovery under such a policy is "precluded." §33-15-403, MCA.

In addition to ignoring the public policy stated in §33-15-403, M&M and the Michelettis fail to identify any public policy requiring attorneys to maintain malpractice insurance. Neither Montana's legislative branch nor Montana's judiciary have set forth public policy requiring attorneys to maintain professional liability coverage. The general assertion that insurance is beneficial to consumers does not identify a public policy recognized by the Montana Legislature.

CONCLUSION

The parties agree that from 2008 until 2014, David McLean stole client funds from M&M's trust account. The parties agree that David did not disclose those activities to ALPS in the application for the Policy. ALPS has established, and the parties have not refuted, that ALPS relied upon the misrepresentations in the application in issuing the "claims made and reported" Policy.

The District Court was presented with undisputed facts and an unambiguous statute. §33-15-403 specifically allows rescission of an insurance policy under these specific circumstances. The District Court correctly held that the Policy was rescinded, was void *ab initio*, and provided no coverage for any party to the Policy or claimant under the Policy. ALPS respectfully requests that this Court affirm the District Court's Orders, and enter judgment in favor of ALPS.

DATED this 31st day of May, 2017.

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CERTIFICATE OF COMPLIANCE

I certify that this brief is printed with a proportionately spaced Times New Roman text, typeface of 14 points, double-spaced, with one inch margins. The word count, as calculated by Wordperfect X7 is 9,645 words, excluding tables and certificates.

Dated this 31st day of May, 2017.

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